HILLSIDE ADVISORS LLC

March 30, 2015

Hybrid Vigor℠

The Hillside Convertible Advisory Letter

Volume 2 Issue 13

I Can See Clearly Now

Inside

Features
2 The Ugly 20: All Shook Up
5 HOCS 20

Investment Ideas
7 Qihoo 360 Update

Other
13 On-Deck Circle (COMM)

Dear Friends,

What a great time. Volatility seems to be coming back. We're in the midst of a fantastic NCAA tournament, with opening day just a week away and the final Kentucky Derby prep races being run. We seem to have made it through a vicious winter reasonably unscathed--though lots of tires and wheels wouldn't agree.

Did I mention that volatility seems to be back? At least, it sure seemed that way in the semiconductor and health-care names last week. Not that those are important areas for convertibles or anything…

One of my criticisms of our market is that those of us who've been in it for some time let our frustrations color the way we present to the outside world. Even as someone who's been a self-appointed spokesman for the asset class for years, I know I've been guilty now and then. Last week, when Whiting Petroleum announced its big financing, my eyes played a trick on me and focused on the equity and straight debt portions, glossing completely over the major-league convertible. I emailed my colleagues complaining. They, of course, saw the convertible portion mentioned quite prominently, and figured I was being sarcastic. In truth, I'd just become conditioned to assume companies will overlook this marvelous--and highly in-demand--financing tool.

So let's make the onset of spring, sunshine, baseball, the Triple Crown, and lots of other good stuff be a positive. Who knows, maybe we'll even overcome the clouds of misguided Treasury regulations. A guy can hope, right?

Bill

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Hybrid Vigor is published every week on Mondays.

The next issue will be published on April 6, 2015.

All Shook Up

Bill Feingold and Curt Peters

A quick refresher. HARP, or Hillside Adjusted Risk Points, is best thought of as a warning measure for bonds exposed to a blend of absolute price decline and premium decay. The higher the HARP, the more dangerous the bond. HARP tends to be highest for bonds in the 120-130 "death trap" range.

What a week! Crushing stock declines shuffled the deck of the Ugly 20, bringing in three new members and driving out three bottom dwellers. Aside from the top five spots, most bonds found new homes on the Ugly 20. Yet, average HARP remained nearly unchanged with only a 0.04 gain to 9.38 HARP. Astonishingly, this all happened with an average 3.2% stock decline and 2¾ points of bond decline. One bond in particular was responsible for the majority of the average declines, though quite a few others put in a jolly good effort. Some gained in HARP with a falling price, while others gained in HARP with a rising price. Still yet others lost in HARP with the same price moves. We mention this to remind that HARP is a measure of risk, despite all else.

Let's skip the yellow jersey leader and go straight to the new number two, Red Hat 0.25% of 2019, up from 3rd by way of a 10.10% stock move and a concomitant bond increase of 6¾ points. Once again, RHT blew past earnings estimates giving support to all those who believe-- believe in risk cloaked with investment-grade career security, perhaps. The bond gained 0.93 HARP to settle at 12.22 HARP. That's two points back of RPM, but already into an air where few other bonds have ever dared to venture. To put some numbers on it, there is a 19½ space between the current 124¾ price and parity after accounting for 4½ years of measly coupons. Or to put it another way, the stock has to gain 20% in the next 4½ years for today's bond price to break even. Yes, the stock has rip-roared the past few months, but the volatility is still a mid-20s figure. For those that love the name and know it well, the risk might not seem so daunting. Though for those same investors, one can ask, "Why not just buy the stock?" as the risk is nearly the same. We know, we know, investment-grade convertible bond mandate. And to think that some schools still teach efficient-market theory!

Number three on our list, Lam Research 1.25% of 2018, is a bond we haven't written about in a while. Mostly because it was a 'going somewhere' bond – going up and out of the Ugly 20 due to its increasing high dollar price. What a difference a week makes. With a stock correction of 9.07% and an equally corrective bond price decline of 8¾, the bond climbed up from 5th to 3rd, now with a 10.80 HARP. Yes, semiconductors took it on the chin this week. Things are not as nasty as with RHT, for LRCX has only 12¾ points to fall to touch parity after accounting for coupons. But both RHT and LRCX have nearly the same stock volatility, so despite sitting beside one another on the Ugly 20, the gap between them in risk is big enough to drive a Mack truck through. Don't let that Mack truck of risk swipe you on the way.

Both Illumina bonds contracted in HARP just enough to make the dazzlingly ugly sheen on both bonds dim just a little. The Illumina 0.5% of 2021 bond was down 1¾ points in price related to a stock accident of -4.5%, not enough mind you to be dollar neutral. If you are wondering how a bond which fell by less than its dollar-neutral slip was able to decline in risk, remember that this bond is looking at par as its risk floor, not parity. And the closer it gets to par, the less of a loss this bond can inflict on an investor. Hence, the lower HARP this time round. Same story for the Illumina 0% of 2019 as well. Another way of looking at this--not surprisingly to hedgers--is that those brave enough to attempt "reverse hedges" (we'll be politically correct) on these hideous bonds are more likely to score big on the upside than the downside.

Coming in from 24th to 20th this week was new invader NuVasive 2.75% of 2017. A small HARP increase of 0.38 to settle at 7.79 HARP was all that was required. NuVasive's problem is a 10¾ spread to parity after accounting for coupons, coupled with a high 20s volatility. It doesn't sound so bad, until we mention that

it has only 2.25 years to get it all done. Many bonds sit their entire lives in the fat of the multi-dimensional risk zone with great promise, but the tolling of the bell inevitably separates the doers from the talkers. With a 122¾ price, sizable premium, and time getting short, NuVasive gets and deserves a high HARP score. That old Etruscan, Ciena 3.75% of 2018, put in for the show this week. A stock decline of 7.08% gave way to a bond price contraction of 4½ points, enough to move from 29th to 19th by clocking in a 7.98 HARP. The bond price of 122½ leaves a lot of space beneath it for troubles, 9½ points to be exact should all not go according to plan. That's a fall to par (after giving effect to the healthy coupon), not parity. If we measure it to parity, the fall is 14½. To take some of the pressure off of this bond, the stock is going to have to live up to its promised low 40s volatility. If it does, this bond could still work out rather nicely, at least for hedgers.

Wherefore art thou, SanDisk? We lost SNDK 0.5% of 2020 this week. From 16th to gone. Given the devastating collapse in the stock of 25.8% on the back of some very disappointing revenue guidance, we were hoping to point out a little bit of sunshine in the fact that the big risk in the bond was no longer there. If you were an outright investor (the dominant flavor in this zero-rate era), however, you most certainly don't want to hear another word about SNDK. Well, what the Lord giveth, the Lord taketh away.

Or is it what the Lord taketh away, the Lord giveth? In the case of the Ugly 20, it's both. The other one, SNDK 1.5% of 2017 came all the way up from 104th to 11th! The risk overfloweth in this one. A bond which was at 173¾ and approaching adulthood of delta one, was snapped back into the multi-dimensional risk zone with a price of 137¾. That's a 36-point decline in a single week, and a HARP gain of 5.56 in single week. A new one for the HARP record books to be certain. At the current moment the bond has about 8 points of potential loss after accounting for coupons. The problem is that the chiming of the maturity bells are starting to make everything ever so hurried. A high 30s volatility could really come in handy in the next 2.3 years.

We will say this much for SanDisk. It's rarely boring. We think it's worth mentioning here that when we put the 0.5% on our original Ugly 20 last summer, a number of our readers cried havoc and let slip the dogs of war. In truth, the hedgers were right--there has been plenty of opportunity to make money here, even though the bonds did leak premium in the early days of the Ugly 20. The outrights, though, have reminded us of the brilliant Canadian comedian Russell Peters' impression of his father threatening him. "Someone gonna get hurt real bad." That was our message last summer. Our view was that HARP, as a diagnostic tool in this name, suggested double-barreled exposure by either wicked stock decline or slow-bleed premium decay, thanks to the mix of premium and price point.

As we said, SanDisk is rarely boring. Intrepid outright souls might be swapping, dollar-for-dollar, into the 1.5% in the spirit of delta restoration. For hedgers, the order of the day would seem to be either to unwind the winning 0.5% or perhaps substitute some calls for shares. The market, after all, has a wonderful tendency to bid up volatility too late, to shut the barn door after the horse has already scampered a mile away. Or, since we're just a handful of weeks from the first Saturday in May, call it a mile and a quarter.

Hillside Ugly 20 List (Prices as of March 27, 2015)

	Convertible	Price	Stock	Premium (%)	Premium (pts)	HARP
1	RPM International 2.25% 2020-12-15	118.25	47.80	30.9	27.91	14.22
2	Red Hat 0.25% 2019-10-01	124.75	76.52	19.8	20.62	12.22
3	Lam Research 1.25% 2018-05-15	132.00	72.04	14.3	16.51	11.34
4	Illumina 0.5% 2021-06-15	116.00	187.17	57.6	42.40	10.80
5	Omnicare (Exchange) 3.25% 2035-12-15	117.25	76.80	17.7	17.63	10.36
6	Jazz Pharmaceuticals 1.875% 2021-08-15	117.50	175.42	33.7	29.62	9.38
7	NVIDIA 1% 2018-12-01	119.00	21.38	12.3	13.03	9.35
8	Salesforce.com 0.25% 2018-04-01	119.50	66.55	19.2	19.25	9.21
9	Emergent BioSolutions 2.875% 2021-01-15	115.50	28.52	31.2	27.47	9.09
10	Priceline.com 0.35% 2020-06-15	112.75	1135.19	30.6	26.42	9.04
11	SanDisk 1.5% 2017-08-15	137.75	64.59	9.1	11.49	8.70
12	US Steel 2.75% 2019-04-01	122.25	24.78	24.7	24.21	8.63
13	BioMarin Pharma 0.75% 2018-10-15	150.50	128.78	10.1	13.81	8.52
14	Synchronoss Tech 0.75% 2019-08-15	115.50	46.94	30.7	27.13	8.31
15	Workday 0.75% 2018-07-15	121.25	85.06	18.6	19.02	8.26
16	Illumina 0% 2019-06-15	111.25	187.17	51.0	37.57	8.16
17	Rambus 1.125% 2018-08-15	122.25	12.71	16.1	16.95	8.15
18	ServiceNow 0% 2018-11-01	121.50	78.47	14.5	15.39	8.00
19	Ciena 3.75% 2018-10-15	122.50	19.17	29.0	27.54	7.98
20	NuVasive 2.75% 2017-07-01	122.75	44.60	16.0	16.93	7.79

Sources: Bloomberg, Kynex

HOCS℠ 20

Bill Feingold

A quick refresher. HOCS, or Hillside Overall Convertible Score, measures the attractiveness of a bond, taking into account both upside potential and downside protection. HOCS is not a theoretical model but a rating system that assigns points to a number of different characteristics of each convertible. HOCS can theoretically lie anywhere from 0 to 100. In practice the average score for a broad group of convertibles is typically around 50. 60 is a good score, 70 is excellent, and 80 is exceptional.

Despite a bad week for stocks, the HOCS 20 proved the value of convertible bonds by tripling in value.

Early April Fools.

In truth, though, the performance of the subgroup really wasn't bad at all. The HOCS 20, with Tesla getting back to falling after a rare week of upside, lost 60 basis points during a week that saw the major stock averages drop by about 2%. The stocks underlying the HOCS 20 fell 1.64%.

It helped that Qihoo 360, which dominates the top of the HOCS 20 with three leaders (kind of like Michael Jackson on the early 1980's pop charts), actually put in another good week. The Qihoo bonds aren't especially equity sensitive—the one with the biggest delta, the 1.75%, only participates in about a third of the common's performance. Still, they say that in the kingdom of the blind, the one-eyed man was king, and this week Qihoo's one eye was enough.

Biotech stocks took a beating in the market last week, so it's no surprise that the HOCS 20's quasi-representative, ANI Pharmaceuticals, gave back the previous week's gains. The ANI convertible fell 4% in sympathy with the stock's 6% decline. It's a good thing the HOCS 20 doesn't have too many names that move this way—otherwise, we could barely call it a real convertible sub-index. Of course, that wouldn't stop the folks at some other joints. CWB fell by a cool 1.53% last week, for instance, or about three-quarters of the major stock averages. Something tells us there could be more where that came from.

The only new shooter on this week's list is recent issue Gogo, rejoining after dropping off because of price appreciation. Gogo is one of those tricky names with limited safety, but a lot of growth and visual appeal. Of course, just because our rules send a name away from the HOCS 20 doesn't mean you have to act accordingly.

Getting the boot was Insulet 2%, not through any fault of its own, but simply because in a market with lower prices overall, staying put is not always good enough to remain on a countercyclical subgroup. Also just missing the list was a name we've liked for some time, Restoration Hardware, which ultimately rose thanks to good results despite so-so guidance. Still, with a HOCS in the mid-60's and a lot of balance and safety, you could do worse than finding a place in your shed for these bonds, even after the recent gains.

The broader HOCS 100, still in development mode, lost 1.02% this week—somewhere between the more cautious HOCS 20 and the highly equity sensitive CWB. HOCS 100 is now up 2.94% year-to-date, subject to all the necessary caveats for an index we're still tweaking, but one that we think is going to be an important benchmark in our market before long.

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Hillside HOCS 20 List

	Description	Convert	Stock	HOCS Overall	HOCS Growth	HOCS Safety	Yield	Premium
1	Qihoo 0.5% 2020-08-15	85.00	52.09	79	75	89	7.51%	104.5%
2	Qihoo 2.5% 2018-09-15	95.25	52.09	79	71	94	5.95%	102.9%
3	Qihoo 1.75% 2021-08-15	77.50	52.09	75	79	69	7.94%	79.7%
4	Invensense 1.75% 11/01/18	98.50	15.26	74	80	61	2.19%	41.3%
5	Twitter 1% 2021-09-15	98.00	50.01	71	79	55	1.32%	52.2%
6	IGI Labs 3.75% 2019-12-15	104.50	8.77	71	83	46	2.48%	33.2%
7	Web.com 1% 2018-08-15	92.25	18.89	71	75	62	3.45%	70.9%
8	Solar City 1.625% 2019-11-01	88.50	50.17	70	82	47	4.42%	47.3%
9	Tesla Motors 1.25% 2021-03-01	83.50	185.00	70	75	59	4.45%	62.4%
10	Tesla Motors 0.25% 2019-03-01	87.25	185.00	69	71	64	3.78%	69.7%
11	GOGO 3.75% 2020-03-01	97.50	19.11	68	84	37	4.32%	21.7%
12	Solar City 2.75% 2018-11-01	103.75	50.17	68	81	42	1.67%	27.5%
13	SunPower 0.875% 2021-06-01	98.25	31.68	68	62	79	1.17%	51.2%
14	Twitter 0.25% 09/15/19	98.00	50.01	68	73	57	0.71%	52.2%
15	Shutterfly 0.25% 02018-05-15	99.25	45.72	67	59	81	0.49%	39.3%
16	Renewable Energy 2.75% 2019-06-15	93.50	9.40	66	72	54	4.46%	31.9%
17	Am Realty 3.75% 2020-12-15	98.75	9.90	66	74	50	4.00%	51.1%
18	ANI Pharma 3% 2019-12-01	113.75	61.94	66	78	41	0.05%	27.6%
19	HomeAway 0.125% 2019-04-01	95.75	30.87	66	59	79	1.22%	61.8%
20	Herbalife 2% 2019-08-15	83.25	43.17	66	66	64	6.45%	66.4%

Sources: Bloomberg, Kynex

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March 30, 2015

Qihoo 360 Technologies (QIHU) - Value Play or Trap?

George Lynch

Introduction

Talk about not being able to catch a break! On March 9, Qihoo 360 announced consensus-beating results. The very next day, the company's stock traded down approximately 5%, continuing its year-long meltdown. In the last two weeks the stock has finally been able to catch a bid, however slight. Still, at $52.09 per share, the stock is only slightly off its 52-week low ($44.56-105.49). Given this trading action, we find ourselves grappling with the question: does the company represent a solid value opportunity? Or, is it destined to become an also-ran among Chinese Internet companies, and a value trap as a result? Ultimately, with each of the company's three senior convertible issues trading below par, it appears to be a great time to reevaluate each.

Each of the three bonds continues to score well on a HOCS (Hillside Overall Convertible Score) basis. The average of the three scores comes in at an attractive 78 Overall / 75 Growth / 84 Safety. However, the safety score of the 1.75% Senior Convertible Notes due 2021, the company's longest dated issue does trail that of the 2.50% and 0.50% Senior Converts due 2018 and 2020, respectively, by a not-insignificant margin. This lower safety score reflects the "time subordination" as well as the correspondingly greater equity sensitivity.

				HOCS Score			Bond	Stk.	%	YTM/	Put
Issuer / Description	Coupon	Maturity	Amt.	Overall	Growth	Safety	Price	Price	Prem.	Put	Date
Senior Cvt. Notes	2.500%	09/15/18	600	79	71	94	95.25	52.09	102.9%	5.95%	09/15/16
Senior Cvt. Notes	0.500%	08/15/20	518	79	75	89	85.00	52.09	104.5%	7.51%	08/15/17
Senior Cvt. Notes	1.750%	08/15/21	518	75	79	69	77.50	52.09	79.7%	7.94%	08/15/19

Sources: Company filings, Bloomberg, and Hillside Advisors

So, Where's the Value?

It's important to note that a large segment of the Chinese Internet sector has been under similar selling pressure. However, QIHU's common has suffered disproportionately due in large measure to what we consider to be a more convoluted business model and product offering. As a result, investors in certain quarters have called the company's long-term competitiveness into question. Yes, QIHU does face a variety of pressures, particularly as it continues the roll-out of its mobile strategy. Still, there is considerable value associated with the company's core businesses, in our opinion.

Over the near term, we expect QIHU's product/service line-up to continue to meet with strong demand and for revenues, earnings, and cash flow to continue to grow at a steady rate. Furthermore, the company's $6.6 billion equity market capitalization should provide even the biggest naysayer with some degree of comfort with respect to the value of this enterprise, at least through the debt-convert portion of the company's capital structure.

As we see it, those businesses (centered on online advertising and Internet value-added services) not only remain intact, but continue to grow and build overall enterprise value. At the end of the day, we consider the company's common sell-off to be grossly disproportionate to the risks faced. So, in terms of the company's overall capital structure, where do we see value?

2.50% Senior Convertible Notes due 2018 – A Yield-to-Put Trade

QIHU's shorter maturities benefit the most from the company's significant cash balance and still meaningful free cash flow generation. Thus, despite QIHU's challenges, we consider the company's 2.50s due '18 to be extremely attractive from a yield-to-put perspective. (The 2.50s enjoy a September 15, 2016 par put.)

The company has been actively buying back common shares the last year of so. In fact, it recently completely its previously announced $200 million buyback initiative. However, retiring bonds at a (perhaps meaningful) discount to par offers a better pathway to unlocking value than would further stock buybacks, in our opinion. Hence, addressing the 2.50s due 2018 should be a company focus. At an approximately 95.25 dollar price, the 2.50s trade to a 5.95% yield-to-put. Not bad for a potential one and one-half year piece of paper.

1.75% Senor Convertible Notes due 2021 – A Murkier Picture Emerges

However, the picture becomes murkier with respect to the 1.75s due '21. The 1.75s are currently quoted at 77.50, translating into a 7.94% yield-to-put. Clearly, the lower dollar price reflects uncertainty in the QIHU story the further out in time you go. The company's ability to retire the 1.75s should not be a concern as long as it continues to generate and build cash at something akin to the current rate. However, if that no longer proves to be the case, this issue could become more problematic than the two preceding.

Holders of the 1.75s due '21 must grapple with challenges relating to $1.1 billion in debt being retired in front of their bonds, as well as potential liquidity pressure. This pressure could become a concern if the company were to invest significant sums on various strategic investments or joint ventures, or launched another stock buyback. Moreover, investors must not forget about the company's Variable Interest Entities (VIE) structure which places severe limitations on a debtholder's rights and remedies in the event of financial distress. We're not suggesting that QIHU is in dire straits at all. However, given the plunge in the company's stock the past twelve-plus-months, it's a risk that warrants mentioning. (See footnote below for greater detail.)

As such, the 1.75s are probably more appropriate for the bull in the crowd. Still, given the converts' equity sensitivity (after taking into consideration the bonds' delta and premium) as well as the aforementioned VIE-associated risks, from a risk/reward standpoint, we would suggest that the more bullish among us focus their attention on the common stock itself.

Credit Waterfall

Qihoo 360 Technology Co. Ltd. (Dollars in Millions)	31-Dec-14	Total Debt (Cum. Bal.)	Adj. EBITDA Multiple	Net Debt (Cum. Bal.)	Adj. EBITDA Multiple
Current Share Price	$52.09				
Shares Out. (Millions)	124.0				
Latest Twelve Months:					
EBITDA	342				
EBITDA (Adj.)	437				
Free Cash Flow	189				
Cash & Cash Equivalents	1,706				
Senior Secured Debt	0	0	0.0x	NM	NM
Senior Unsecured Debt					
2.500% Senior Cvt. Notes due 2018	600				
0.500% Senior Cvt. Notes due 2020	518				
1.750% Senior Cvt. Notes due 2021	518				
Total Unsecured Debt	1,635	1,635	3.7x	(71)	-0.2x
Total Debt	1,635	1,635	3.7x	(71)	-0.2x
Equity Market Cap.	6,459	---	---	---	---
Enterprise Value	6,388	---	---	---	14.6x

Sources: Company filings, Bloomberg, and Hillside Advisors

Business Description

QIHU was founded in 2005. A free security product launch (2008) was key to the explosive platform growth which followed. The level of growth achieved soon positioned the company for its IPO (2011). Next in line, the company launched its internet search engine platform (2012).

Today, QIHU is the leading provider of Internet and mobile security products in China. The company's PC-based products and services monthly active users (MAU) now total a record 509 million, representing a 96.1% share of the overall market.

The company also provides users with secure access points to the Internet via its market leading web browsers and application stores. QIHU has also built one of the largest Internet platforms in China and monetizes its massive MAU base through a combination of online advertising and Internet value-added services offered on its open platform.

While these highlighted metrics are impressive, the reality is that QIHU does face fierce competition. Baidu, Inc. (BIDU) is the single greatest competitive threat. By several accounts, BIDU captures a share of the

search market that nearly rivals QIHU's command of the MAU count. Furthermore, while QIHU's share of the search market remains significant, the company has consistently struggled to monetize this important base. As a result, revenues, earnings, and cash flow (along with associated year-over-year growth) have all felt some degree of pressure.

Recent Highlights

Despite these pressures, Q4 2014 revenues totaled $431 million, in-line with consensus estimates, but up 94.6% in the year-over-year comparison. Online advertising revenues and Internet value-added services, driven by solid search and mobile monetization gains accounted for the growth. Sequential quarterly improvement was principally driven by seasonal strength in online advertising. However, a better-than-expected ramp-up in enterprise security products and services accounted for solid revenue growth as well.

Online advertising revenues totaled $243 million, up 70.8% year-over-year, the result of a continued ramp-up in search monetization and an improved contribution from the nascent mobile advertising platform. Search ad revenues totaled $109 million, a 189% year-over-year improvement. Top categories on the search front were automobiles, e-commerce, education, finance, lifestyle and tourism. Search ad volumes and revenues should remain strong over the foreseeable future, driven in part by the medical search category (launched February 2015) and continuous improvement in the aforementioned leading and more established content categories.

Internet value-added service revenues totaled $167 million, which are largely derived from game platform operations, were up 112.2% year-over-year. Game revenues reached $136 million in the most recent quarter, a 116% year-over-year improvement. Game revenues consisted of web games ($77 million) and mobile games ($59 million). Web games decreased 11% year-over-year, a greater than expected decline, attributable to the ongoing secular shift for game developers from PCs to mobile as well as the lack of attractive content. On the other hand, mobile game revenue continued to surge, recording a 207% year-over-year gain. We expect this category to be the main driver of future game revenue growth.

During Q4, QIHU began to provide fee-based enterprise security products to institutional clients. Positively, the enterprise security business performed better than hoped, the result of a strong early acceptance of the company's products and a strong seasonal pattern.

New initiatives should and will be closely monitored. The strategic initiative between QIHU and Coolpad will help the company build a product base combining both hardware and software, with the goal of bolstering its position in the mobile app store business together with mobile search. Other initiatives such as 360 Kids Guard, 360 Family Guard, and 360 Secure Router, all part of QIHU's Internet-of-Things strategy, combined with the company's various wireless product efforts, continue to receive positive feedback.

Finally, QIHU's balance sheet and liquidity remain sound. The company's debt load is essentially limited to the three convert issues. As a result, total debt leverage (relative to adjusted EBITDA) measures a reasonable 3.2 times. Furthermore, given $1.7 billion in cash & cash equivalents, net debt leverage pulls up in slightly negative territory. In addition, free cash flow (FY 2014 = $189 million) relative to total debt measures a still-strong 11.6%.

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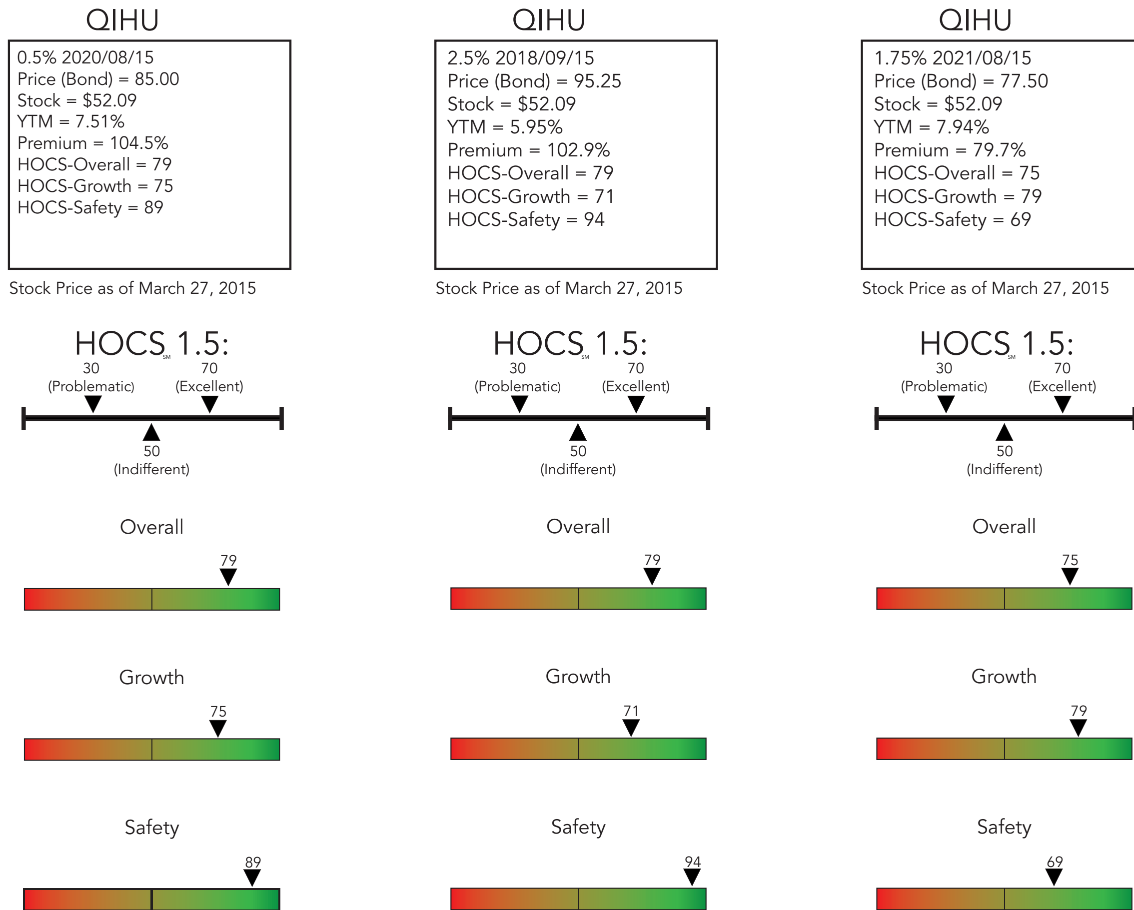
Financial Summary

Qihoo 360 Technology Co. Ltd.						
	Fiscal Years Ended			3 Mos. Ended		
(Dollars in Millions)	31-Dec-12	31-Dec-13	31-Dec-14	31-Dec-13	31-Dec-14	31-Dec-14
Revenues	329	671	1,391	222	431	1,391
Y / Y Change	----	104.0%	107.2%	----	94.6%	----
Gross Profit	296	583	1,085	191	328	1,085
Operating Profit	49	103	259	9	108	259
EBITDA	67	148	342	23	132	342
EBITDA (Adj.)	117	269	437	98	156	437
Interest Expense	(1)	(6)	(26)	(4)	(10)	(27)
Income Tax Expense	(11)	(23)	(51)	(9)	(21)	(51)
Capital Expenditures	(74)	(121)	(171)	(19)	(38)	(171)
% Revenues	22.5%	18.1%	12.3%	8.5%	8.8%	12.3%
Free Cash Flow	31	118	189	66	87	189
Total Debt	0	600	1,635	600	1,635	1,635
% Total Debt	NM	19.7%	11.6%	10.9%	5.3%	11.6%
Gross Margin	90.0%	86.9%	78.0%	86.4%	76.1%	78.0%
Operating Margin	14.8%	15.4%	18.7%	4.0%	25.1%	18.7%
EBITDA Margin	20.2%	22.1%	24.6%	10.2%	30.7%	24.6%
EBITDA (Adj.) Margin	35.6%	40.2%	31.4%	44.2%	36.2%	31.4%
EBITDA (Adj.) / Interest	94.5x	41.9x	17.1x	22.3x	15.2x	16.4x
EBITDA (Adj.) - Capex / Interest	154.0x	60.7x	23.8x	26.6x	19.0x	22.8x

Sources: Company filings, Bloomberg, and Hillside Advisors

(1) Free Cash Flow calculation for the latest twelve months ended September 30, 2014 has been adjusted to account for interest expense relating to the company's three Convertible Senior Notes as if each issue were outstanding beginning on January 1, 2014.



Footnote – Variable Interest Entities (A Quick Description)

We would be remiss in not highlighting the risks relating to the company's use of the Variable Interest Entities (VIE) structure. While the following represents our brief take on the general workings of the mechanism, we strongly suggest that investors fully vet the subject with legal counsel for a comprehensive understanding of all the risks involved relating to this most opaque structure.

By way of background, Chinese Internet companies have come to increasingly rely on foreign investors to finance growth. However, the Chinese government restricts foreign investment among the country's so-called Internet Content Providers through a series of foreign equity caps and complex licensing requirements. Moreover, Chinese companies must obtain governmental permission to list overseas. To bypass these restrictions, Chinese Internet companies use the complex VIE mechanism. VIEs, usually based in tax havens such as the Cayman Islands, are established as holding companies that contractually link foreign investors and Chinese firms.

In theory, the VIE structure guarantees that economic benefits flow to the foreign investors. Here are just a few of our favorite twists associated with this "creative" mechanism: 1) operating control of the business remains within the Chinese firm, "seemingly" to comply with Chinese law; 2) contracts behind the structure are only enforceable in China; and 3) listing VIEs on U.S. exchanges is illegal in China.

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March 30, 2015

The On-Deck Circle
CommScope Holding Company, Inc. (COMM): Time to Sharpen Your Pencils

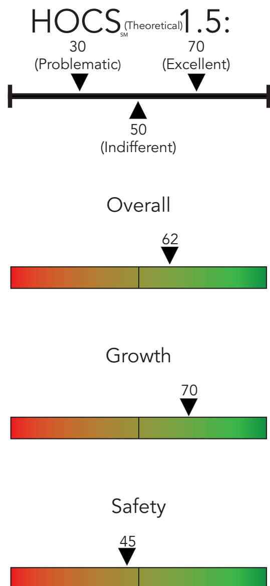
Hillside Staff

Theoretical Bond Pricing

COMM

1.75% 2020/03/30
Price (Bond) = 100.00
Stock = $28.99
Premium = 35.0%
HOCS-Overall = 62
HOCS-Growth = 70
HOCS-Safety = 45

Stock Price as of March 27, 2015
*Estimated HOCS Scores



Each week, we feature a company that we think would be a great convertible issuer. We hope to persuade you and perhaps ultimately the company itself.

Our ideal candidate is trading within 20% of (and preferably much closer to) its 52 week high, has a low debt-to-capital ratio, and has a compelling usage for new capital. Generally, these companies will be convert rookies. Feel free to let us know if you want to nominate a particular company. If we agree with you and publish your nomination, you will receive an honorable mention in the newsletter!

Smartphones are becoming a new body part. Located somewhere between the brain and hands, mobile devices have become woven into the human experience, and forgetting your cell phone on any given day is like losing a thumb. The need to be even more connected to the information highway is only growing, and it is expanding on a global basis. That is the catalyst for CommScope, which manufactures the piping for cellular and fiber optic systems, and its recently announced $3 billion acquisition of a portion of TE Connectivity's network solutions business.

CommScope divides its business into three segments: Wireless, Enterprise and Broadband. CommScope ranks number one globally in many product lines and has achieved steady growth to pay down debt.

The Wireless segment covers macro cell site equipment for towers and small cell site equipment for distributed antennas that improve reception in difficult environments such as cities. The Enterprise segment focuses on clients such as data centers and commercial buildings with high bandwidth needs including data, video and voice. Products include everything from hardware such as fiber-optic cable to network monitoring software. Broadband sells cable and communications equipment to support multi-channel video and high speed data systems provided by multi-system operators (MSO).

While humming along in the first nine months, the Wireless segment closed 2014 in weak fashion as wireless providers slowed infrastructure investment. Fourth quarter revenues clocked in at $485 million, down 9% year-over-year. CommScope sees the market stabilizing in the first half of 2015 before returning to growth in the second half.

In contrast, the Enterprise and Broadband segments are experiencing continued growth, compensating for the wireless slowdown. Total 2014 Enterprise revenue was $850 million, up 2.7% over 2015. 2014 Broadband revenues totaled $511 million, up 5.5% over 2013.

On a consolidated basis, CommScope realized revenue of $3.8 billion in 2014,

up 10% over 2013. Cash flow is strong and improving, rising 36% to $346 million in 2014. 2014 adjusted EBITDA was $857, up from $675 million in 2013. CommScope had a cash balance of $729 million at the end of last year, reducing net debt to 2.3x from 3.2x last year.

For 2015, CommScope is guiding flat to slightly down revenue of $3.65 to $3.8 billion, adjusted earnings per share of $1.95 to $2.05 and another year of strong cash flow.

Despite the tepid revenue outlook, CommScope equity shares have held the 30%+ gains made subsequent to CommScope's blockbuster announcement that it was acquiring the telecom, enterprise and wireless assets of Swiss-based TE Connectivity. The deal is transformative for CommScope, creating a $5.8 billion company on a combined basis. The transaction reduces CommScope's reliance on the wireless market by increasing revenues in the enterprise and broadband sectors. The acquisition also brings geographic diversification thanks to TE Connectivity's strong presence in Europe, Middle East, Africa and Asia Pacific.

CommScope will pay for the acquisition in cash, financing it with cash-on-hand and up to $3 billion in debt. Because of the impending increase in debt load, CommScope has been placed on ratings review for downgrade by Moody's. However, given the success of last week's Whiting Petroleum convertible security, we think CommScope could pull-off a similar $1 billion convertible bond, offering a significant savings to the company over straight debt.

As a point of comparison, we are modeling the straight debt at a credit spread of 500 basis points, resulting in a savings of $52.5 million annually.

	Issue Amount	Annual Estimated Coupon	Annual Estimated Cost Savings
5 Year Bullet Straight Debt	$1 billion	7.00%	$70.0 million
5 Year Convertible	$1 billion	1.75%	$17.5 million
Estimated Annual Savings		5.25%	$52.5 million

Pro forma convertible credit statistics for the combined CommScope entity post merger (where available) are:

Pro Forma Cash:	$500 million
Pro Forma Debt:	$5.7 Billion
Pro Forma annual EBITDA:	$1.2 Billion
Last 12 month FCF:	$250 million (CommScope Only)
Pro Forma Leverage:	4.75x
Pro Forma Net Leverage:	4.3x
Mkt Cap	$5.6 billion (Current CommScope)

*Issue Proceeds will go to finance the businesses being acquired from TE Connectivity

Using a credit spread of 500 basis points and a volatility of 35%, we estimate that the convertible bond would look like this:

Issue Price	100.0
Issue Size	$1 billion
Maturity	5 years
Coupon	1.75%
Premium	35%
Call	Bullet
YTM	1.75%

Sources: Bloomberg, Company Filings, Kynex

This hypothetical convertible bond receives a HOCS (Hillside Overall Convertible Score) slash line of 62 Overall / 70 Growth / 45 Safety.

The safety score is low because management is planning to fund the deal mainly through debt. While the lower HOCS safety score highlights the risk of the deal from a balance sheet perspective, we think the market would look through to the combined company's strong pro forma cash flow and $150 million in identified synergies, and offer the convertible bond issue a warm reception. After all, the convertible market knows this name from an earlier life. CommScope had an outstanding convertible before Carlyle took the company private in a $3.9 billion deal in 2010. CommScope returned to the public markets again in 2013.

Growth scores well as the planned acquisition alone increases revenues by 50%.

Banks have submitted debt financing commitments for a planned close by the end of 2015, so it is not too early to start sharpening your pencils.

For more information regarding CommScope and a potential convertible issue, please contact John Anderson at 646-665-4025.

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